LIBRARY
SUPREME COURT, U. S.
Office - Supreme Court, U.S.
FILED
JUN 19

No. 1019

In the Supreme Court of the United States

OCTOBER TERM, 1957

JAMES R. WATKINS AND LUCILE L. WATKINS,
Petitioners

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE UNITED STATES IN OPPOSITION

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
Assistant Attorney General,

HARRY BAUM
GRANT W. WIPRUD,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	2
Statement	4
Argument	7
Conclusion	13

Citations

Cases:

Allen v. *Werner*, 190 F. 2d 840	12
Bliss, E. W., Co. v. *United States*, 253 U.S. 187	9
Cory v. *Commissioner*, 230 F. 2d 941, certiorari denied, 352 U.S. 828	9
Lawrence v. *United States*, 242 F. 2d 542	9
Rollman v. *Commissioner*, 244 F. 2d 634	9
Switzer v. *Commissioner*, 226 F. 2d 329	9
United States v. *Carruthers*, 219 F. 2d 21	9
Watson v. *United States*, 222 F. 2d 689	11

Statutes:

Internal Revenue Code of 1939:	
Sec. 117(a) (26 U.S.C., 1952 ed., Sec. 117(a))	2, 7, 8
Sec. 117(q) (26 U.S.C., 1952 ed., and Supp. IV Appendix, Sec. 117(q))	3, 7, 8
Internal Revenue Code of 1954, Sec. 1235 (26 U.S.C., 1952 ed., Supp. II, Sec. 1235)	8

Miscellaneous:

S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5082-5083)	8, 12
S. Rep. No. 1941, 84th Cong., 2d Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229)	8

In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 1019

JAMES R. WATKINS AND LUCILE L. WATKINS,
Petitioners

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 16-28)[1] is reported at 149 F. Supp. 718. The opinion of the Court of Appeals (Pet. App. 26-31) is reported at 252 F. 2d 722.

---

[1] Record references herein are to the appendix to the taxpayers' brief in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered on February 26, 1958. (Pet. App. 32-33) Taxpayers' petition for a writ of certiorari was filed on May 23, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in ruling, on the facts presented, that a transfer of patent rights by the taxpayer[2] constituted a license, not a "sale" of the patents under Section 117(a)(4) of the Internal Revenue Code of 1939 nor a transfer of "all substantial rights" in the patents under Section 117(q) of the same Code, so that royalties received by the taxpayer from the licensee were taxable as ordinary income rather than as capital gain.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) * * *

* * * *

(4) [As amended by sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-term capital gain.*—The term "long-term capital gain"

[2] Taxpayer James R. Watkins is referred to throughout this brief as "the taxpayer," since taxpayer Lucile L. Watkins is a party to this litigation solely by virtue of the fact that she is the wife of James R. Watkins and filed joint returns with him for the tax years in question.

means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * *

(q) [As added by Sec. 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404] *Transfer of Patent Rights.*—

(1) *General rule.*—A transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) *"Holder" defined.*—For purposes of this subsection, the term "holder" means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) *Exceptions.*—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person.

For purposes of this paragraph, the term "related person" means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24(b).

(4) *Applicability.*—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred.

(26 U.S.C., 1952 ed., and Supp. IV Appendix, Sec. 117.)

STATEMENT

The material facts, as found by the District Court (R. 16-19) and as set forth by the Court of Appeals (Pet. 27-29), may be summarized as follows:

On April 17 and October 9, 1934, patents were issued to taxpayer covering a wood cleated corrugated shipping container. In March, 1937, taxpayer entered the employ of Dillman Industries, Inc., a manufacturer of shipping containers, and executed an agreement with Dillman giving the corporation a nonexclusive license to manufacture and sell the containers covered by his patents. Licenses had also been granted by taxpayer to five other midwestern firms. The manufacture and sale of the containers proved successful and in 1940, after two more improvement patents had been issued to taxpayer, he and the management of Dillman deter-

mined that the best way of obtaining wider acceptance of the patented container was through extensive licensing to other firms in the industry. To this end, they organized in 1940 a new corporation, Watkins Patents, Inc., the function of which was to grant limited territorial licenses to manufacture and sell the container. Taxpayer received 20 per cent of the stock and the remaining 80 per cent was acquired by Dillman, its officers and shareholders. (R. 16-17; Pet. 27-28.)

To carry out the plan, five agreements dated April 27, 1940, were executed simultaneously, consisting of agreements severally between taxpayer and Watkins Patents, Inc. (Ex. A), between Watkins Patents, Inc., and Dillman Industries, Inc. (Ex. B), between taxpayer and Dillman (Ex. C), between taxpayer, Dillman, and Watkins Patents, Inc. (Ex. D), and between taxpayer and Watkins Patents, Inc. (Ex. E). Under the primary agreement (Ex. A), taxpayer transferred to Watkins Patents, Inc. "the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents, * * * together with all licensing agreements heretofore made under said patents" by taxpayer. In consideration of this transfer, the corporation agreed to issue to taxpayer 20 per cent of its stock and to pay him $3,800 in cash plus one-third of the net royalties the corporation received from the patented products sold, or an amount equal to 1 per cent of the net sales price of all patented products sold, whichever was greater. In addition, the corporation further agreed to give taxpayer a nonexclusive license to manufacture and sell at a reduced royalty rate of 1½ per cent of the net sales price. Taxpayer could use this license only after leaving the employ of Dillman; but he could then use it in association

with any company, whether or not a licensee of Watkins Patents, Inc., and in the event that he severed his connection with such company it would still retain the right to operate under the license at the reduced royalty rate. Taxpayer could also continue to bestow upon any other company with which he might become associated in the future the same licensing rights. The agreement further provided that in the event of litigation involving the patents the corporation had a duty to defray the costs of litigation up to the amount of $10,000, with the option of paying or refusing to pay additional amounts. If the corporation refused to pay additional amounts, taxpayer had the right to carry on the litigation at his own expense with certain provisions for reimbursement in the event of his successful prosecution or defense of the litigation. The agreement further provided that sublicenses to be issued by the corporation were subject to the approval of the taxpayer. (R. 17-18; Pet. 28-29.)

Under the agreement between Watkins Patents, Inc., and Dillman (Ex. B), a non-transferable, nonexclusive license was given Dillman to manufacture and sell at a reduced royalty of 1 per cent of net sales, to be increased to 1½ per cent if taxpayer left the employ of Dillman. The agreement between taxpayer and Dillman (Ex. C) canceled the original license from taxpayer to Dillman and provided a new employment contract between Dillman and taxpayer, which either party could terminate at the end of a year. The three-party agreement (Ex. D) provided for Dillman's acceptance of the transfer of patent rights by taxpayer to Watkins Patents, Inc., and contained certain other provisions, including Dillman's promise to loan Watkins Patents, Inc., certain amounts for the purpose of

paying litigation expenses that might arise in defense of taxpayer's patents. The fifth agreement (Ex. E) gave back to taxpayer a sublicense from Watkins Patents, Inc., under the terms of the first agreement between them (Ex. A). (R. 18-19; Pet. 29.)

The District Court found as ultimate facts that the primary agreement between taxpayer and Watkins Patents, Inc. (Ex. A) did not effect the transfer from taxpayer to the corporation of all substantial rights in the patents involved, and that the parties did not intend that the agreement should effect such a transfer. (R. 19.) It accordingly concluded that the agreement did not constitute a sale or assignment of the patents in question, but only the grant of a license; and that, therefore, the income reported by taxpayers in their 1949-1952 returns, derived from the licensing of the patents, was ordinary income and not capital gain. (R. 20.) The Court of Appeals agreed and affirmed the judgment. (Pet. 31.)

ARGUMENT

1. The ultimate question presented is whether royalties received by a transferor of patent rights constituted ordinary income or capital gain. This is a question which has been much litigated over the years, in a great variety of factual contexts. As to royalties received by taxpayer in the tax years 1949 and 1950, the answer depends on whether the transfer effected a "sale or exchange" of patents, within the meaning of Section 117(a)(4), *supra*, pp. 2-3. As to the royalties received in the tax years 1951 and 1952, the answer depends on whether there was a transfer of "all substantial rights" to the patents within the meaning of Section 117(q), *supra*, pp. 3-4. This latter provision,

added to the 1939 Code in 1956, is substantially the same as Section 1235 of the 1954 Code, and was enacted in order to make the provisions of that section retroactive to 1950. S. Rep. No. 1941, 84th Cong., 2d Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229). Thus the legislative history of Section 1235 is pertinent in determining what constitutes "all substantial rights" to a patent under Section 117(q). Of particular relevance is the following passage in the committee report (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5082-5083)):

> The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments * * *. * * * It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones.

In keeping with Congress' view of the test under "existing law"—*i.e.*, that the entire transaction should be "examined in its factual context"—it has been repeatedly held that whether a given transfer of patent rights constitutes a "sale" under Section 117(a)(4) or a transfer of "all substantial rights" under Section

117(q) depends upon all the facts and circumstances of the particular case. The decisions, including those relied upon by taxpayer, have taken into account the conduct of the parties, the language of the instruments, and other circumstances surrounding the transfer, with a view to making a realistic assessment of the substantiality of the rights, if any, retained by the transferor. See, *e.g.*, *Rollman* v. *Commissioner*, 274 F. 2d 634 (C.A. 4th); *Lawrence* v. *United States*, 242 F. 2d 542 (C.A. 5th); *Switzer* v. *Commissioner*, 226 F. 2d 329 (C.A. 6th); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9th). Cf. *E. W. Bliss Co.* v. *United States*, 253 U.S. 187, 192; *Cory* v. *Commissioner*, 230 F. 2d 941 (C.A. 2d), certiorari denied, 352 U.S. 828. Whatever the language employed, it is clear that the courts have looked to the individual facts in order to apply the "realistic test" adopted by Congress, and have concluded that a patent "sale" occurred only when satisfied that the transferor divested himself of all substantial rights in his patent.

In the case at bar, the District Court found (R. 19) that taxpayer did not transfer all substantial rights in his patents to Watkins Patents, Inc. Its detailed factual assessment in support of this finding (R. 22-26, 28) shows that it construed the five agreements involved in the context of the testimony of taxpayer and his witnesses (R. 20) "relative to the history of the parties to the contracts * * *, the business relationship of the parties and the negotiations before and during the making of the agreements as well as some testimony as to what the parties to the contracts actually did pursuant to them." It concluded that Watkins Patents, Inc., was created only for the purpose of

carrying out the single function of sublicensing;[3] and that while taxpayer (R. 26) "transferred with his right hand a bundle of legal interests which he claims constituted complete ownership, he took back with his left hand a substantial number of those interests." And, among other retained interests discussed in detail (R. 25-26), the court emphasized the following (R. 28):

> Once he had left the employ of Dillman Industries, Inc., which he could do at his own volition after a year, Watkins could associate himself with another to manufacture and sell and that other would gain and retain a license even after Watkins had become disassociated from him; and thereafter Watkins could make a new association with someone else, who would thereby also gain a license and so on without limit. At the same time he could veto the granting of licenses by Watkins Patents, Inc. to someone of whom he did not approve. He possessed power to do more than his transferee could do.

In affirming, the Court of Appeals properly held (Pet. 30-31) that the record clearly justified the finding of the lower court that taxpayer failed to transfer to Watkins Patents, Inc., all substantial rights in his patents. In the words of the court below (Pet. 30), tax-

[3] While taxpayers have never disputed that Watkins Patents, Inc., was created with the intent that it serve only as a sublicensing agency, they renew here (Pet. 17-20) their argument below that the primary agreement (Ex. A) was effective as a matter of law to transfer to the corporation the powers to manufacture, use and sell. We believe that the District Court properly rejected this argument for the reasons given in its opinion. (R. 23-25.) However, the Court of Appeals refrained from passing on the question (Pet. 30), noting only (R. 28) the undisputed fact that the sole *intended* function of Watkins Patents, Inc., was to sublicense.

payer "emerged from the transaction possessed of so many rights and interests both present and future that much less than a complete transfer was achieved by the transaction."

2. Contrary to taxpayers' assertion (Pet. 10-16), there is no conflict with the decisions of other courts. The most that can be said of the many cases invoked by taxpayers is that in one or more isolated factual aspects they bore a similarity to the case at bar, *i.e.*, the transferors there involved qualified their transfers of patent rights in ways similar to *some* of the qualifications attaching to the transfer in the case at bar. This the District Court recognized. (R. 26-27.) But, viewed in entirety, not one of the cases cited by taxpayers provides anything like a close parallel to the case at bar—nor do taxpayers attempt to demonstrate such a parallel. Among numerous differences between the factual complex presented here and that presented in other cases, this case is significantly unique in the concurrent presence of three factors: (1) taxpayer's transferee, Watkins Patents, Inc., was not created to manufacture and sell the patented product, but for the sole purpose of sublicensing; (2) taxpayer could veto sublicenses by the corporation at will; (3) after one year, and again, at will, taxpayer could manufacture and sell and, in effect, license others to manufacture and sell. Thus, as the District Court pointed out (R. 28), taxpayer "possessed power to do more than his transferee could do."

These concurrent factors serve to distinguish this case from *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10th), and like cases with which taxpayer claims conflict. (Pet. 15-16). In those cases, the qualifications attached to the transfer were simply conditions subse-

quent beyond the control or volition of the transferor; moreover, they were conditions which did not diminish the immediate grant of exclusive rights to the transferee, but rather were designed to promote the manufacturing and selling operations of the transferee. See *Allen* v. *Werner*, 190 F. 2d 840, 842 (C.A. 5th).

In the case at bar, by contrast, the power of veto and prospective power of sublicensing retained by the taxpayer could not operate to implement and promote the full and exclusive exercise by Watkins Patents, Inc., of the rights inhering in the patents to manufacture and sell the patented container, because the corporation was created only to function as a sublicensing agency. And it is obvious that the retained powers robbed even the corporation's sublicensing powers of any exclusivity. Moreover, the exercise of the retained powers depended solely upon taxpayer's volition, rather than upon any independent event of failure of the transferee to perform its obligations. These retained rights are not conditions subsequent of the kind involved in *Watson* and *Werner*, and it was only conditions subsequent of the latter kind which Congress had in mind when it said (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5083)):

> Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., *a forfeiture on account of non-performance*) are not to be considered as such a retention as will defeat the applicability of this section. *On the*

other hand, a transfer terminable at will by the transferor would not qualify. [Italics supplied.]

Here, the taxpayer retained a power of veto and a prospective power of sublicensing which were not dependent upon such a condition subsequent as "a forfeiture on account of nonperformance." Since taxpayer retained full power to render the corporation's sublicensing power nonexclusive and, indeed, to stultify it altogether by veto, the transactions were akin to "a transfer terminable at will by the transferor [which] would not qualify."

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HARRY BAUM,
GRANT W. WIPRUD,
Attorneys.

JUNE, 1958.

☆ U. S. GOVERNMENT PRINTING OFFICE 1958—469459/P O. 1647